Hearing on Sub-prime Mortgage Issues March 21, 2007

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Thank you for the opportunity to present for discussion the issues that face our nation's banking industry and the communities that we serve with access to quality credit and financial services. I also come here representing some of the non-profit intermediaries that help the regulated depositories reach into the low- and moderate-income markets within the communities that the depositories serve.

Since 1997 I and many of my peers in the regulated depository banking industry have raised the issue of how many of our neighbors and neighborhoods have been systematically preyed upon by the unscrupulous and many cases predatory practices imbedded in the mortgage lending delivery system. Often, although not always, the delivery system has been plagued by mortgage brokers and others driven only by commissions and fees and not in the best interests of the consumer. Recognizing this problem the banking industry and the City of Chicago Housing Department in 2000 established the NORMALsm loan program in partnership with Neighborhood Housing Services of Chicago, Inc. (NHS) to provide capital to refinance customers out of improvident and imprudent loans that their mortgage broker had talked them in to. Often these borrowers were unsophisticated in financial matters. Often these customers were elderly or had challenges with the English language. I cite for example a case (Cook County, Illinois) #04 C 0120 Hernandez v. Euromex Mortgage in which the borrower had been convinced to refinance a mortgage just short of the expiration of a prepayment penalty that cost them an additional $7,000.00 along with other onerous fees and charges that were not fully disclosed to the borrower. Transcripts of the opinion and settlement will be provided upon request.

So, although the problem is just now coming to the attention of Wall Street investment community and the bank regulators, those of us who have seen the "train wrecks" impacting individual home owners in our communities have been dealing with these issues for years. Many of us in the banking community have advocated at the state level to provide more aggressive supervision of the delivery system. The fact is that the state agencies have only recently enacted modest licensing and supervision controls over a burgeoning market of individual brokers. Some states don't even have any regulations that govern the business. The current mortgage delivery system, if properly supervised, can add to the efficiency, lower cost and easier access to mortgage capital for the consumer. Unfortunately the trade-off to efficiency and ease of access has often been to abuse that efficient access to mortgage capital by adding onerous terms and inappropriate, if not outright predatory products that do not fit the "suitability" of the customer's financial condition. Add to that volatile mix the access to exotic mortgage products and you have a formula for financial disaster that only the mortgage broker as originator of the loan benefits from. As I said in open testimony on Predatory lending hearings conducted by then Assistant Secretary for HUD Bill Apgar in 2000 that "the mortgage lending industry has connected the crooks with the capital markets".

There are three major themes that I would like to address with the previous information as a backdrop:

- Where does the capital come from to fuel this problem?
- Do the CRA rules that govern regulated depositories impact capital access?
- Would expansion of the Community Reinvestment Act to other industries in the consumer finance business improve access to quality mortgage products?

Capital Access

Investors have been chasing the buzz of ever higher yields as more conservative similar investment yields have dropped or remained stagnant.

In the last three years, for example, big banks and brokerage firms almost doubled the amount of residential loans they issued, going to $1.1 trillion in 2006 from only $586 billion in 2003 and much less than that in previous years.

To remarket these individual loans the syndicators have moved these loans into collateralized debt obligations and then sold them to pension funds, hedge funds, banks and insurance companies. In 2005 nearly 81 percent of the $249 billion in collateralized debt obligation pools consisted of residential mortgage products.

These obligations contain segments (tranches) that are based on credit quality. The syndicators developed securities that included high yield tranches a large portion of which included sub prime residential mortgage loans.

What used to be imbedded in the sub prime collateralized debt obligations were loans to professionals early in their careers (doctors, lawyers, etc.) where the prospect for future income was somewhat predictable is now surpassed by what the industry refers to as "affordables", loans to home buyers where the anticipation in the increase in home value is the underlying source of quality. Most of these loans are what one would consider exotic (adjustable-rate interest-only loans, 40-year loans and piggy-back second mortgage loans, payment option loans).

So what I see is a mortgage market driven by capital access from Wall Street syndicators driven to provide enhanced rates of return for their investors. The conventional (GSE) market programs have focused on driving capital into low- and moderate-income communities in partnership with community based organizations and local depositories where the prospective home buyer has access to good information that enables them to make informed decisions.

Do the CRA rules that govern regulated depositories impact capital access?

The Community Reinvestment Act (Regulation BB) was designed to address access to credit by all consumers, small businesses and small farms. The fact that the rating system designed in the early 1990's and implemented in 1995 as the "Performance Context" examination rules gives greatest weight to lending in the banks' assessment area (50% of the Large Bank test and more in the new Intermediate Small Bank CRA test).

The Q&A on CRA rules promulgated by the FFIEC give Lending Test credit for loans originated by others. Often the demand in LMI communities for home purchase and small business are in markets where the regulated depository has difficulty penetrating.

Over the years the lenders who were successful in originating loans in those markets found willing investors in and through Wall Street where a business that aggregated loans in CRA-qualifying markets developed. Major nation-wide mortgage wholesale firms, the conventional secondary markets (GSE), and other non-profit intermediaries have been successful in filling the orders from CRA-regulated institutions to improve their performance in penetrating LMI communities. The bank regulators do not give as much inherent CRA credit for such transactions unless they can be qualified as part of Community Development Lending (CDL) segments of the examination. Normally the CDL credit is given when the underlying credit qualifies as a Community Development Loan.

Unfortunately the underlying credit loan characteristics have not been considered in the CRA examination, therefore even loans with exotic terms and onerous conditions can qualify for CRA-eligibility. The loan characteristics (i.e., terms, cost, rate, etc.) until recent changes in HMDA reporting rules have been difficult to determine by the examiners. In 2001 the New York State Banking Commission in part issued the following:

The Department has concerns regarding sources of funding for predatory lending activities, and therefore reiterates its position that favorable consideration for CRA purposes will not be given for loans or investments that violate federal or state consumer protection laws, including fair lending regulations. Although institutions may receive a non-binding, advisory opinion from the NYSBD regarding the eligibility of a proposed activity for CRA consideration pursuant to Part 76 of the General Regulations of the Banking Board, these loans and investments should also conform to the following guidelines in order to receive favorable treatment in a Performance Evaluation:

- **High Cost Home Loan originations by supervised institutions, their subsidiaries and affiliates, in order to receive favorable consideration under the CRA, must comply with Part 41 of the General Regulations of the Banking Board. The Banking Department's examiners will routinely sample**

a portion of an institution's originations in order to determine such compliance.

- **Purchases of High Cost Home Loans, if such loans have been made to low and moderate income borrowers or low and moderate income areas and are otherwise eligible for CRA consideration, should be accompanied by documentation in the files of the purchasing lender sufficient to support the fact that a satisfactory due diligence review was performed by it on such loans.**
- **Investments in mortgage backed securities, if such securities include underlying High Cost Home Loans to low and moderate income borrowers or low and moderate income areas and are otherwise eligible for CRA consideration, should be accompanied by evidence documenting the extent to which a due diligence review was performed by the investor on the underlying High Cost Home Loans**.

The current Q&A for CRA rules does not address the quality of the underlying credit.

Would expansion of the Community Reinvestment Act to other industries in the consumer finance business improve access to quality mortgage products?

It has been argued for years that the access to residential mortgage and small business credit has changed dramatically since 1977, the year that the CRA was enacted. In 1977 the mortgage banking industry was in its infancy, the credit unions were mostly very small affinity-based institutions and the thrift industry was alive (barely) and challenged on how to deal with disintermediation and deregulation.

Much has changed since those days. As you know the basic reason for the enhanced CRA in 1991 was FIRREA, the near-collapse of the deposit insurance system and the need to derive some social benefit from the U.S. taxpayer's bailout of FSLIC and to some extent the FDIC insurance fund.

Well times have changed. The vast majority of the residential mortgage lending in this country is driven by the mortgage banking industry. The mortgage banking industry is supported in many ways by the regulated depositories either through warehouse lines of credit, direct loan purchases or outright ownership of the mortgage banking company. The largest small business lender in the country is American Express, only recently replacing The Money Store as the nation's largest small business lender. Many Credit Unions now are the main source of consumer deposit relationships and many now have huge assets and memberships that defy the affinity definition that were once preeminent and enjoy special tax relief that allows them to offer more aggressive deposit pricing as a result. In addition we have seen foreign companies and internet banks under special bank chartering rules eat up local deposits without much return and little direct or indirect investment in local markets. I am still trying to find one community development deal in Chicago that ING initiated while the sucking sound from deposit outflow in Cook County was heard.

It is important for these other players in the deposit and credit business to play a more significant role in local community development. Our little bank has been fortunate to find a way to drive locally-derived capital into our LMI communities while earning a reasonable return on our investment. We feel that it is important for our survival as a strong bank that our community grows economically and that the residents of our community have access to quality credit and deposit products. We do CRA because it is good business. We also believe that the others who benefit from access to government and government-supported programs (deposit insurance, GSE investments, special tax status, etc.) should also be subject to community development and Community Reinvestment Act-like requirements. In that way the access to capital for LMI markets, small business and small forms would lead to a better quality credit product for all.